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Essays in Fiscal and Monetary Policy

Edited by

M.J. Artis and M.H. Miller

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MONETARY POLICY

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PREFACE

The papers published in this volume have their origin in a seminar series on the interrelationship of fiscal and monetary policy, which was sponsored by the Institute for Fiscal Studies. The meetings were held during the academic year 1977-8, under the chairmanship of Sir Alec Cairncross. Organization was ably provided by Mrs Thelma Leisner, and finance by the Social Science Research Council. We are grateful to these individuals and institutions for their assistance as we are to David Wright, who prepared the index. The delay in the publication of the volume is not their responsibility but ours.

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I

FISCAL AND MONETARY POLICY – AN INTRODUCTION TO THE ISSUES

M. J. Artis

The purpose of this introductory chapter is to provide some perspective on the principal issues discussed in the ensuing chapters of the volume. The seminar series from which these chapters originate was conceived of as focusing upon the kinds of consideration underlying the way in which fiscal policy is approached and assessed in contemporary macroeconomics, and in particular as illuminating the nexus between fiscal and monetary policy. The need for such discussions sprang directly from the observation that, at a time when many of the old certitudes of macroeconomic policy-making had been jettisoned, a stock-taking exercise would be useful. The chapter contributors were approached on the basis that they would have something useful to say in such a context.

There is no doubt that macroeconomics, and thus the theory that purports to guide the formation of monetary and fiscal policy at present, conveys the impression of being something of a shambles. There is certainly much less of a consensus within macroeconomics now than there was in the first half of the 1960s. At the policy level, the combination of inflation and recession has taught policy-makers some hard lessons; and the distress of policy-makers has been accompanied by a series of re-evaluations within analytical macroeconomics, without much sign as yet that anything approaching a new consensus has been reached. Even the statement that ‘we are all monetarists now’, which seemed to have a brief purchase on truth, is in doubt again, since the advent of the ‘second wave’ of monetarism—rational expectations monetarism.

Perhaps one useful way of characterizing the disintegration of consensus and the present dissension within macroeconomics would be to say that experience has cast doubt on the appropriate kinds of abstraction to make in a useful macroeconomics. Economic theory makes a great deal of use of distinctions between the short term and the long term, an analytical ordering that is informed, though not literally translated to calendar time dimensions, by empirical judgements about the relative speeds of adjustment of economic variables. At this level, it is clear that conventional *IS/LM* macroeconomics makes abstractions that clearly classify it as short-term theory. Indeed, the problem is that these abstractions, in the light of experience, seem to classify it as ‘very’ short-term theory. Much of the empirical and analytical advances in recent years seem to consist, on the one hand, of working out the significance and time form of responses of economic variables ‘held constant’ by the traditional analysis, and on the other of extending the analysis to embrace these responses and feedbacks in order to find out what new properties the model has when it is enhanced

2 *Fiscal and Monetary Policy*

in this way. These enterprises have not always gone closely hand in hand, which in itself has contributed a certain disorientation and imparted a kind of restlessness to some of the analytical results, the calendar-time translation of whose steady state properties has often been desperately unclear. It seems that it must be possible to proceed in a more constructive way, for the price of not doing so is not only to prolong professional uncertainty but also, operationally, to confuse policy and deprive it of well-judged guidance. However, that no easy resolution is in sight is perhaps most dramatically demonstrated by the present confrontation of two new 'extreme' paradigms of macroeconomics: the macrodisequilibrium school and the rational expectations school. The latter relies on market-clearing and fast adjustment of prices; the former denies market-clearing and deprives prices of a helpful role in short-run adjustment.

Two reasons why it is not easy to resolve matters suggest themselves. First, it seems clear that the empirical data do not easily yield to the kinds of technique available in such a way as to readily confirm specific hypotheses. Second, it would in any case be naive to suggest that somehow we can, with the aid of empirical economics, arrive at a re-ordering of adjustment processes, allowing for an agreed reassessment of the most suitable abstractions to make for useful macroeconomics, and then proceed to a new consensus. Policy-makers are, or should be, interested in the longer-run consequences of their present actions even if these are not significant within the conventional period of policy relevance. This suggests—to borrow from John Flemming's comments later in this volume—that macroeconomic policy analysis ought to be cast in optimal control terms within which the 'longer-run' consequences of policy can be implicitly impounded in terminal conditions for the period over which policy is explicitly optimized. This has the virtue of avoiding the difficulty of locking macroeconomic analysis mistakenly into either a 'very short-term' or long-term mould, and is a constructive response to the present danger that the Keynesian baby will be thrown out with the bathwater while policy is conducted along monetarist lines, which may be entirely suitable for points on the full employment equilibrium path of the economy yet distinctly unsuited to dealing with the problems of getting back on to such a path.

This of course still leaves open the need to inquire into the nature of the responses suppressed by the conventional *IS/LM* account of macroeconomics, and to find out something about their time form and long-run consequences. This is an agenda involving both empirical and analytical work. In various ways, the chapter contributions to the present volume can be seen as contributing towards this.

One of the key abstractions of conventional *IS/LM* analysis is that it takes as given the stock of assets, both physical and financial, and focuses on flow equilibria. In these equilibria, stocks would be changing, but the abstraction allows the effect of this to be ignored—presumably on the assumption that the time period of reference of the model is, while long enough to be relevant, short

enough that these feedbacks can be reasonably ignored. Some questioning of this presumption is perhaps implicit in the large volume of analytical literature devoted to examining the consequences of explicitly analysing the effects of asset accumulation; and is more explicit in the wealth-related consumption and expenditure functions employed in contemporary UK macroeconomic models. In the present volume David Currie analyses the role of wealth effects in his survey of the 'crowding-out' issue; however, while the formal results of traditional analysis of this issue are affected by the incorporation of the financing identities and wealth effects, Currie makes the point—no less important for being obvious once stated—that 'crowding-out', in conditions short of full employment, where it is predetermined *ex hypothesi* by physical supply constraints, is attributable to the result of the financing policy accompanying the fiscal stimulus. In the chapter contribution by Fetherston and Godley, the crucial role of wealth effects in the CEPG model (of which Fetherston and Godley's model is a version) in underpinning the characteristic 'New Cambridge' proposition concerning the spill-over from fiscal to balance of payments deficits is set out with extreme clarity. In their model (see simulation 1 for the clearest case), there is a desired wealth-income ratio for the private sector, and demand-determined output conditions. As a result, a fiscal stimulus that increases the wealth of the private sector invokes an adjustment of income to restore the desired wealth-income ratio, with a final equilibrium in which the injections of financial wealth from the budget deficit are offset by an equivalent drain from a deterioration in the current balance. While an adjustment of output and an offsetting drain of wealth to the overseas sector are one possible form of evolution of the system, another possible mechanism of adjustment comes via the 'inflation tax'. If inflation occurs, there is a drain of wealth via the implied inflation tax. A mechanism of this kind seems to play an important role in the LBS and NIESR models, as exemplified in the simulations of these models reported in this volume (there is further comment on this below). The analytical work in this area has proceeded without benefit of a well-documented empirical literature, and much of what empirical work there is has implied wealth effects by indirection, rather than directly. One reason for this has been the absence of reliable wealth data. Joe Grice's chapter in this volume, however, besides surveying the existing literature, also adds new evidence based on the use of explicit wealth data. The conclusions of this work are favourable to the existence of significant wealth effects on expenditure, though much remains to be done: not least, of course, to establish the significance or otherwise of wealth effects in asset demand functions.

Another respect in which the *IS/LM* analysis abstracted severely was in its treatment of inflation. This abstraction was of course, long since modified by the attachment of the Phillips Curve to the basic model. But the experience of the accelerating inflation of the 1960s, and the stagflation of the 1970s, led many economists to suggest that a short run in which inflation was so much of an afterthought was an unrealistic time-frame for adequate analysis. The

popularity of the augmented Phillips Curve is an analytical consequence. The chapter contributions in this volume do not seek to deal with the issue directly, but endogenous wage-price responses and the nexus between the exchange rate, wages and prices are clearly significant in the model simulation evidence. And, of course, if wealth effects are important, then so too are inflation-induced wealth effects. Finally, if inflation is treated as endogenous, rather than as orthogonal to the system, the issue of policy measurement and policy-setting must take this into account. This theme recurs in Charles Goodhart's chapter on monetary policy and in the chapters by Budd and Burns and by Neild, where fiscal policy measurement is discussed. Budd and Burns argue that fiscal policy deficit measures should be adjusted for inflation, implicitly because of the tax-like effect of inflation. Neild recognizes, but prefers not to incorporate, this effect in his own preferred measure of fiscal policy. There is no doubt, whatever treatment is accorded to this phenomenon, that plausible orders of magnitude for it are in contemporary conditions very large in relation (for example) to the unadjusted budget deficit.

Traditional analysis also abstracts from, or, rather, makes special assumptions about, the role of expectations. John Flemming's note on the subject elaborates on this issue, which the rational expectations 'revolution' has brought forcefully to our attention. In particular, rational expectations has disconcerting implications for many customary procedures in this area. First, the assumption of rational expectations makes something of a nonsense of some traditional distinctions between the short run and the long run: it can be caricatured as, in fact, making the long run the short-run solution. Second, it suggests that systematic demand management policies will be offset by private sector behaviour. Third, it inhibits recourse to simulation evidence to explore the consequence of different policies and makes more doubtful what can be learnt from past data. These results however do not follow without some amendment when careful consideration is given to a plausible set of behavioural assumptions even in combination with that of rational expectations. Flemming gives some reasons for being sceptical, but they are delivered in a constructive vein; a concession to rational expectations is implicit in his suggestion that monetary targets should be made conditional.

Policy issues are particularly addressed by Neild, Goodhart, Middleton and Budd and Burns. The former presents a measure of fiscal policy, based on the well-known high employment budget deficit measure. However, Neild is after slightly different game from that pursued by most users of this measure. He has in mind a measure that is designed to indicate whether long-run fiscal policy is appropriately set. This, in conjunction with some empirics, leads him to reject the notion of differential weighting of budget components and the use of the measure for short-run policy description. One argument in the latter context is that the availability of appropriate model simulations cuts out the need for such a policy indicator. Goodhart introduces other arguments against this kind of

policy indicator, too, pointing out *inter alia* that in principle the effect of a change in the setting of any one policy instrument depends on the joint setting of all other instruments. Since not everybody has equal access to appropriate simulations (which should in principle be capable of dealing with Goodhart's objections), it may be that a valid need still exists for short-term indicators of policy stance. Budd and Burns suggest that an appropriate one is the fiscal deficit adjusted (upward) for inflation and for declines of output below capacity (trend). They suggest that such an adjusted fiscal measure is in fact the correlate of a monetary measure (the growth of real money supply), indicating that the two amount to the same thing; so that, although the policy *instruments* are different, measures of policy stance are really much the same. As their model indicates that the PSBR drives the money supply (*ceteris paribus*), and that output changes are essentially transitory, the adjustment in the long run working through to prices via the exchange rate, this is not surprising.

The National Institute paper sets out to describe the Institute's monetary sector and an important part of its fiscal sector, and provides simulation evidence of the response of the model as a whole (discussed below).

The paper by Middleton describes the way in which monetary and fiscal policy interact within the framework that is employed by the Treasury to examine these issues. The description embraces an account of the Treasury's monetary model, as well as an account of the way in which fiscal and monetary policy are seen as interacting. It is clear from this account that the financing identity of the government budget constraint, together with the role of the external sector, are seen as binding monetary and fiscal policy closely together.

This is also reflected in the simulations from the London Business School and National Institute presented in this volume. It seems worthwhile briefly to compare and comment upon these, and the most closely comparable simulation from the Fetherston-Godley chapter (although, as explained below, this simulation does differ in some important aspects from the other two).

COMPARATIVE SIMULATIONS

The three papers from the modellers provide evidence based on simulations of the way in which fiscal policy works. This evidence is worth careful inspection in so far as it indicates what factors it is that those concerned with the forecasting and analysis of the British economy have found important to take into account, and in so far as it demonstrates the net result of the interaction of a relatively complex set of forces. While analytical methods can illuminate outcomes for comparatively small systems, simulation methods seem indispensable for understanding the behaviour of more complex systems. They do, of course, have limitations. To begin with, it would be wrong to suppose that such methods somehow reveal the truth about the way the economy behaves; rather, they reveal the properties of systems built by modellers. Some of these properties will

have been consciously built in by the modellers on the grounds that economic theory should be used to condition the empirical estimates, so that both the specification of relationships to be estimated and the estimation procedure already reflect to a degree the intuition of the modeller, who is perhaps most likely to 'let the data speak freely' when it comes to the estimation of lags in relationships. Second, simulation runs are counterfactual experiments or hypothetical examinations of the system, conducted under the assumption that everything about the system as specified remains unchanged in the event of the 'experiment' being run. But it is clear that this assumption is sometimes a very strong one; agents learn from, and come to anticipate, the results of policy actions and may modify their behaviour accordingly. A valid set of descriptive equations for the 1967 devaluation would not describe adequately the result of an equivalent devaluation today. Finally (though this is not an exhaustive list of qualifications), there is every reason to believe that initial conditions in the economy will affect the outcome of an experiment, but in the simulations reported here no attempt was made to pin them down to an identical time period, although all are for the post-floating period.

The once conventional wisdom concerning the effect of fiscal policy on the level of output in a small open economy with a floating (freely flexible) exchange rate maintained that it would be zero. This result depended on the assumption that, with perfect (flow) capital mobility, a bond-financed fiscal expansion must result in an appreciation of the exchange rate to preserve zero overall balance at an unchanged interest rate, reducing net exports by an amount sufficient to 'crowd out' entirely the fiscal expansion. The current and expected spot rate were assumed identical in this analysis, interest parity being thus preserved on the uncovered interest differential. Even with imperfect capital mobility, the assumptions of this analysis prohibited any positive output effect of bond-financed fiscal policy.¹ Money financing and monetary policy, generally, were by contrast assumed capable of affecting output by way of exerting a depreciating influence on the exchange rate and an expansionary effect on net exports.

Within this framework, some power could be restored to fiscal policy by amending the rather implausible assumption that exchange rates are not *expected* to change; since interest parity refers to the comparison of *covered* differentials, an alternative equilibrium could be envisaged providing for domestic interest rates to stand above (or below) world rates to an extent exactly offset by the expected depreciation (or appreciation) of the domestic currency. Thus, a fiscal expansion that led to an over-appreciation of the currency relative to its expected exchange rate could in principle provide for a *positive* output effect (always assuming that the demand for money is not completely interest-inelastic), at an increased interest rate.

A feature of the fiscal policy simulations reported below (Table 1.1) is that the output multipliers are rather low. However, as indicated in the bottom half of the table, this result has little to do with a deteriorating net export balance

and nothing at all to do with an appreciation of the exchange rate. In a number of key respects, the view taken by UK econometric modellers achieves a consensus on the appropriate departure to make from the once-conventional wisdom sketched above.

First, as against the assumption made there that domestic wages and prices (the GDP deflator) are invariant to the exchange rate, UK modellers tend towards the assumption that an exchange rate change is not very 'effective' (or not effective at all) in the long run. The speed with which, and the way in which, exchange rate changes dissipate themselves in offsetting (or nearly offsetting) domestic wage and price changes varies considerably from model to model, however. The Cambridge Economic Policy Group (CEPG) assume a real-wage resistance form of wage equation (see Fetherston and Godley, Chapter 10 below, p. 170) and normal cost-based domestic prices; import prices in sterling terms reflect domestic prices to a small degree, and export prices in sterling terms reflect world prices (given the exchange rate) to a greater degree. The NIESR employs an augmented Phillips Curve (where, however, the coefficient on inflation is 0.8 rather than unity) and pricing assumptions qualitatively similar to those of CEPG. The London Business School (LBS) provides for a higher gearing of domestic prices directly to world prices, and for a 'Scandinavian' view of wage determination. All three models provide an interval in which a devaluation is effective, but CEPG and LBS allow no long-run effectiveness and the NIESR only a small degree of effectiveness in the long term. On the volume side, all three models recognize lagged responses which produce a J-curve of deteriorating current balance performance to begin with, followed by improvement and then by renewed deterioration as the reduction in exchange rate effectiveness catches up with the lagged volume responses. Space does not allow more expanded treatment of the models' wage-price-balance of payments-sector here,² but we have established the main outlines. In the long run, wages and prices are homogeneous of degree 1 in the exchange rate (or nearly so, in the case of NIESR); but lags in the pass-through of exchange rate changes to wages and prices, and in volume responses to relative prices and profitability, ensure that a regime of continuous depreciation would, in these models, improve the balance of payments.³

A second important departure from the once-conventional wisdom occurs in the modelling of capital flows. Where the traditional theory assumed a flow form of capital mobility, the bulk of empirical work in the field assumes that the correct specification is of a capital stock adjustment type. The Treasury is most explicit in the modelling of this feature, of which a striking characteristic is the oddly low degree of mobility implied by freely estimated coefficients, an oddity of which the authors are well aware.⁴ Apart from the continuing flow associated with growth in world wealth, the implication of this approach to capital flow modelling is that a continuing capital flow can only be associated with a maintained *change* in interest differentials, a condition ruled out in consideration of

long-run equilibria. For this reason the interest rate is likely to fall out of account in the examination of equilibria pertaining to a perturbation of a flow condition, especially as similar stock-adjustment considerations apply to the consideration of the financing of budget deficits.⁵

A third respect in which contemporary modelling departs from the once-conventional wisdom is in its handling of exchange rate expectations. As already indicated, the maintained assumption of the original statements of the conventional wisdom was that exchange rate changes were not expected to take place. Removing this assumption requires, to take its place, an account of how the exchange rate *is* determined. Here again, the Treasury has given the most detailed account among the model-builders. In this account, the spot exchange rate is required to move, in relation to its expected value, in such a way as, in combination with the highly imperfect capital stock adjustment response of capital flows, to provide for an expected appreciation/depreciation sufficient to clear the overall balance of payments. The expected value of the exchange rate is depicted as a weighted average of the current and a 'long-run equilibrium' rate, given by a relative money supplies formulation or a more direct version of purchasing power parity (PPP). Very roughly speaking, the view seems to be that the long-run exchange rate has to be one that will clear the current account, as follows naturally from the notion that capital flows are essentially capital stock adjustment in form. The LBS seems to adhere to a similar view, although their account is somewhat shorter on the dynamics of short-run adjustment in the exchange rate, which is made to depend rather more directly on a relative money supplies hypothesis. In the NIESR model, the exchange rate reflects PPP considerations directly, together with the uncovered interest rate differential and 'speculative' terms, while in the CEPG model, the exchange rate is considered to be a direct decision variable.⁶

A final highly significant departure from the conventional wisdom is provided by the incorporation in all the models of an 'inflation tax' arising from the hypothesis that in the face of inflation, which erodes the value of financial assets, agents will save in order to restore the real value of their wealth. In each of the products of the model-builders reported on here, the consumption function (private expenditure function in the case of the CEPG) is so specified as to provide for a rise in the savings ratio (as conventionally measured) in the face of inflation. The same is also true of the Treasury model.

The simulation results reported in Table 1.1, now hopefully fall into place. The table reports three simulations from this volume and one drawn from elsewhere (Ball, Burns and Warburton, 1978). The reason for including the latter is that the model from which it is derived is identical in all respects to that from which the Budd-Burns simulation (reported in this volume) is derived, and has the advantage that it corresponds exactly, in the shock that it simulates (a government spending increase), to that given by the NIESR and by Fetherston-Godley in this volume. The latter has, however, a slightly different status from

TABLE 1.1
Simulations of fiscal policy

A. Dynamic multipliers for fiscal policy: ratio of GDP increase (ΔY) to government spending stimulus (ΔG) or real tax cut ($-\Delta T$)†

	NIESR (ΔG)	Budd & Burns ($-\Delta T$)	Ball, Burns & Warburton (1978) (ΔG)	Fetherston & Godley (ΔG)
Quarter 1	0.68	0.07	1.01	
4	0.81	0.17	0.85	Year 1: 1.15
8	0.68	0.14	0.74	
12	0.43	0.02	0.54	
16	0.24	0.03	0.62	Year 5: 3.27

B. Crowding-in (+) and crowding-out (-): † ratio of expenditure changes to ΔG : quarters 4, (16)‡

	/ ΔG	NIESR	Ball, Burns & Warburton (1978)	Fetherston & Godley
Government spending	ΔG	1.00 (1.00)	1.00 (1.00)	1.00 (1.00)
Consumer spending	ΔC	0.14 (-0.46)	-0.14 (-1.31)	0.15 (2.02)
Investment & stock-building	($I+\Delta S$)	- (-0.13)	0.38 (0.91)	
Net exports	$\Delta(X-M)$	-0.33 (-0.17)	-0.12 (0.02)	
GDP	ΔY	0.81 (0.24)	0.85 (0.62)	1.15 3.27

† The simulation results quoted assume – except in the case of Fetherston–Godley (F–G), endogenous earnings, interest rate and exchange rate. In F–G, the exchange rate is chosen to clear the current account.

‡ For F–G, years 1, (5).

Sources: NIESR – Chap. 8, simulation 4, pp. 133–5; Budd & Burns – Chap. 9, Table 1, pp. 00–00; Ball, Burns and Warburton (1978) – simulation 2; Fetherston and Godley – Chap. 10, Table 3, pp. 00.

the others, inasmuch as it combines a government spending and devaluation shock sufficient to realize specified output and balance of payments targets with unchanged interest rates, while the NIESR and the two LBS simulations endogenize all of the money supply, exchange rate and interest rate. None of the simulations is a bonds-only financed fiscal shock, the money supply increasing in each.

Taking each in turn, it can be readily seen that in none of the first three simulations reported is the potency of fiscal policy especially marked. The lower half of the table attempts to give some indication of the source of the ‘crowding out’ simply by recording the change in expenditures as a proportion of the

initiating increase in government expenditure.⁷ This arithmetic indicates clearly enough that the relatively low values of the sixteen-quarter dynamic multiplier can be attributed to a crowding out of consumption expenditure. The same is true of the second LBS simulation, since the difference between this and the one appearing in the lower half of the table is apparently due (see Ball, Burns and Warburton, 1978) solely to the difference in import content between government and private consumption. It seems clear enough, moreover, that the crowding-out of consumption is to be attributed to an 'inflation tax', arising principally from the inflation induced by the depreciation in the exchange rate; this depreciation is not sufficient to cancel the income-induced rise in imports in the NIESR model, but is certainly helpful in that respect, as comparison of the NIESR's fixed and floating exchange rate simulations (Chapter 8 below, pp. 133-5) indicates. This is, in outline, what is to be expected. On the capital stock adjustment view of capital flows, increasing interest rates are required to stabilize the exchange rate in the face of current account deterioration, and these produce declines in wealth and consumption as well as reducing interest-sensitive expenditures (house-building especially). In the flexible rate framework, exchange depreciation avoids the need for such large interest rate movements and boosts net exports, at the expense of inflicting greater inflation, an inflation tax and cuts in consumption on the economy. While the fiscal multiplier is small, in accord with traditional theory, the crowding out falls primarily on consumption rather than on net exports, the exchange rate depreciating rather than appreciating. Although the timing and magnitudes are rather different, a similar summary describes the LBS simulations. Interest rates, again, affect both capital flows (implicitly) and debt holdings in stock adjustment fashion. The exchange rate depreciates with fiscal expansion, and crowding-out is due to the effect of inflation on consumption.

The Fetherston-Godley simulation is in rather different shape, though analytically the underlying model shares many of the same basic features: thus, the expenditure function allows inflation to reduce consumption; the wage-price system ensures that devaluation is 'effective' in the short run but ineffective in the long run; while interest rate changes adjust desired capital stock allocations. However, the exercise carried out in the Fetherston-Godley simulation differs from that in the other simulations, as already explained. The devaluation is aimed to clear the current balance in year 5, and (presumably) the positive contribution of net exports is close to its maximum along the adjustment path at that point; by contrast, the LBS and NIESR simulations both embody a continuously flexible exchange rate and exhibit positive current deficits by quarter 16. Since, in the Fetherston-Godley run, the exchange rate is managed so as to clear the current account, no part of the adjustment is borne by the capital account or interest rate adjustment. The constant interest rate-no devaluation multiplier is augmented by the engineered increase in competitiveness. Given the parameter values assigned in the model, the combined increase in the size of the initial shock to government expenditure together with the change in real net

exports associated with the engineered devaluation must be approximately twice the size of the fiscal shock alone, so the substantial long-run GDP multiplier is not particularly surprising.⁸

CONCLUSIONS

The papers reprinted in this volume deal with various aspects of fiscal and monetary policy and their interrelationship, with particular reference to conditions in the United Kingdom. A central theme of this introductory chapter has been the disintegration of the consensus model of macroeconomic policy, identified with conventional *IS/LM* analysis and, in its policy aspect, the Tinbergen instruments—objectives framework. It has been suggested that analytical developments in the field can be viewed as explorations of the consequences of relaxing the simplifying assumptions of the conventional wisdom, relaxations that in a general way may be related to empirical judgements that traditional analysis suppressed economic responses that are in fact relevant over policy-relevant horizons. It has also been suggested that the reconstruction of a greater degree of consensus about policy impacts will require better informed empirical judgements and a more subtle analytical handling of the time dimensions of policy impact.

The chapters that follow do not indicate that any such reconstruction is yet at hand, but there is a wide measure of agreement among them about points of departure from conventional analysis. This is most notably true in respect of the significance given to the asset accumulation effects of fiscal policy. The question of the mode of financing of fiscal deficits—the management of the composition of the portfolios to which fiscal deficits add—is somewhat less systematically explored. One significant problem here is undoubtedly the difficulty of accounting for foreign exchange market behaviour and the formation of expectations in this market. The tension between the discipline imposed by foreign exchange market expectations and the exercise of discretion by the domestic policy-makers is an issue of the greatest practical importance to an open economy like that of the United Kingdom. Some of the papers in this volume, corresponding to the experience of the mid-1970s, reflect a particular form of resolution of this tension—the announcement and pursuit of monetary targets by the authorities. The difficulties with this resolution are many; but in particular, it seems to be a rather one-sided resolution in which substantial surrender of domestic policy-makers' discretion is involved; fiscal policy then also becomes heavily dependent upon monetary policy (a striking reversal, some would say, of the policy pattern of the 1960s). It seems likely that there is greater scope for discretionary demand management policy than this, and that in retrospect this period will be seen as a policy episode enjoined by highly specific historical circumstances: the more so as there is every reason for thinking that the pursuit of monetary targets in the Western world has failed to provide an answer to the problems to which it was addressed, while aggravating others.

The issues raised by the contributions to this volume are thus far from settled.